

U.S. Homeowners Market

Casualty Actuarial Society Spring Meeting

Klayton Southwood, FCAS, MAAA

May 2013

TOWERS WATSON 

Agenda

- Significant Trends and Developments
 - Capital
 - Reinsurance and Financial Markets
 - Regulation and Residual Markets
 - Weather and Catastrophes
 - Consumer Demographics
 - Coverage Selected
 - Product Offering and Policy Differentiation
 - Underwriting
 - Rating
- Towers Watson's Predictive Modeling Survey

Significant Trends and Developments

- **Capital**
- **Reinsurance and Financial Markets**
- **Regulation and Residual Markets**
- **Weather and Catastrophes**
- **Consumer Demographics**
- **Coverage Selected**
- **Product Offering and Policy Differentiation**
- **Underwriting**
- **Rating**

Capital

- Many new start-up companies have entered the market over the past few years
 - Many new Florida homeowners companies entered the market with a focus on taking business from Citizens; however, some have cancelled/non-renewed Citizens' take-out business already
 - Many Florida writers expanding to other states to diversify exposure
 - Capital requirements for start-up companies in Florida increased in 2012
- Rating agencies are focusing on companies' catastrophe management philosophy and understanding
 - Expect management to be versed in the catastrophe models and understand model assumptions
 - Support use of AIR, RMS or a blend
 - Understand/support inputs related to storm surge, secondary modifiers and non-modeled factors
 - Continued focus on data quality and validation procedures related to catastrophe modeling data
 - Shifting focus from capital to earnings, especially earnings volatility
 - Need to improve underwriting strategy and pricing
- M&A activity
 - For homeowners and other personal lines, M&A activity remains a viable option for companies looking to grow inorganically and/or diversify into new geographic areas
 - However, the number of Personal Lines carriers seeking business through acquisition far outweighs the number of carriers willing to sell
 - This tends to limit the number of deals that close, despite the fact that many companies are actively looking

Reinsurance and Financial Markets

- Ample reinsurance capacity
- Expect 5-10% premium reductions in 2013
 - Headed for reductions before Hurricane Sandy; Sandy tempered reductions
 - Companies looking to increase overall coverage
 - Increasing aggregate limits
 - Offset by higher retentions to make reinsurance coverage more affordable
 - Expect rates to level, barring no significant catastrophe events (Hurricane Ike or larger)
- Increased use of capital markets
 - Increased interest in alternative risk transfer mechanisms, such as catastrophe bonds and side-cars
 - Primary insurers tend to issue the majority of cat bonds, while side-cars have largely been confined to reinsurer sponsors
 - Cat bond and side-car activity cooled considerably in 2009 amid the financial crisis that widened credit spreads
- Influx of international reinsurers (India, Europe, Korea) looking to diversify
- Aggregate covers hardest to place
 - New aggregate cover hard to find
 - Aggregate covers hit each year in 2008 – 2011
 - Uncertainty in price adequacy
 - Becoming a core portion of reinsurance purchasing plans
- Least capacity in Northeast
 - Least comfort with catastrophe models; few events to validate accuracy of the models
 - Capacity began tightening after Hurricane Irene (2011) and continued after Superstorm Sandy

Regulation and Residual Markets

- Rates may be suppressed due to availability/affordability issues
- Building codes are becoming more stringent, which may reduce severities. At the same time, more stringent building codes will increase both replacement costs and premiums
- Several states are considering or have implemented tax credits or mandatory premium discounts for homeowners who improve the wind resistance of their homes
- State funds providing windstorm coverage
 - Explosive growth in state-run property insurers as coastal development and property values rise and private insurers limit coastal exposure
 - Many states attempting to reduce residual markets through:
 - Rate increases
 - Incentives for private insurers to write policies
 - Reduced coverage offered (capping limits of coverage, changing policy forms and implementing of hurricane deductibles)
 - Many state-run insurers operate at substantial deficits
 - Requirement that wind pool policyholders also purchase flood insurance
 - Avoids coverage disputes on damage resulting from wind or water

Weather and Catastrophes

- Companies are spending more time analyzing catastrophe exposures
 - Extensive use of modeling for underwriting and rating
 - Manage exposures and spread risk
- Hurricane/wind
 - Significant changes to RMS model in 2011 (version 11)
 - Significant changes to loss estimates, especially inland, resulting from Ike
 - Allows for user input/assumptions for storm surge
 - Increases to PML of 200% common
 - Expecting more changes to RMS version 13 later this year
 - Expecting decrease in medium term rates (MRT) of 10-20% resulting from lower forecasts due to stabilizing sea surface temperatures
 - Impacts vary by state
 - Higher deductibles mandated by statute in some states
 - Insurers now offering percentage deductibles up to 20% of the home's value
 - Currently hurricane deductibles offered/mandated in 18 states and DC
 - Companies offering/requiring hurricane deductibles for properties further inland
- Tornado
 - 2011 record year for tornadoes, followed by 2008
 - Costliest type of natural disaster in 2011 due to the number of urban areas hit
- Wildfire
 - 38 states have wildfire risk, with greatest risk in California, Arizona, New Mexico and Washington
 - Home construction in wildland areas pose an increasing threat (increasing spread of suburbia)

Weather and Catastrophes

- Earthquake
 - The potential cost of earthquakes is growing due to increasing urban development in seismically active areas and the vulnerability of older buildings, which may not have been built or upgraded to current building codes
 - Earthquakes have occurred in 39 states and caused damage in all 50 states since 1900
 - Increasing focus on earthquake exposure resulting from international quakes
- Non-traditional types of catastrophes pose a threat
 - Man-made catastrophes from pollution
 - Defective materials, such as Chinese drywall
 - Florida sinkhole
 - Texas mold

Consumer Demographics

- Increasing population density in coastal areas
 - Puts upward pressure on both number of residences and average value of residences
 - Coastal counties account for 17% of the U.S. land area, but 53% of the U.S. population
- Social media is changing insurers' marketing approach to prospective consumers and employees
 - Insurers are engaging consumers, not just selling or showcasing product, through social media (e.g., Facebook, MySpace, Twitter)
 - Insurers are looking for ways to tap into the growing consumer base in future generations through social media
 - Some insurers have dedicated employees tracking online discussions, including correcting the public record about the insurer
- Home foreclosures continue to be an issue
 - Vacant homes at higher risk of loss, including windstorm, fires, flooding, freezing pipes, mold and infestation
 - Foreclosed homes create higher exposure to loss for neighboring homes

Coverage Selected

- Homeowners are reevaluating coverage
 - Comparing prices from different carriers
 - Raising deductibles to reduce cost
 - Cleaning up credit reports to improve pricing/tier
 - Updating or upgrading home (e.g., wiring, plumbing) and/or protection devices (e.g., alarms, hurricane shutters) for premium discounts or acceptance
 - Staying with current company for loyalty discounts
 - Bundling coverage (e.g., auto, home, life) to reduce cost and chances of non-renewal
 - Conducting home inventories/cataloging
 - Forgoing filing small claims to avoid non-renewal, losing discounts or tier penalty
 - Evaluating coverage offerings, such as pre-packaged coverages
- There is a growing trend to forgo optional coverages, such as earthquake and flood
 - High cost of premiums
 - Greatest threat after an earthquake is fire, which is covered by traditional homeowners policies (but anti-concurrent causation clause may eliminate coverage)
 - Potential government aid after a major catastrophe

Product Offering and Policy Differentiation

- Some insurers have scaled back coverage and/or increased required deductibles without a commensurate drop in premiums
 - Deductibles — Require separate, higher wind/hurricane deductible
 - Anti-concurrent causation clause — Eliminates coverage for an insured peril (e.g., wind damage/flood, fire/earthquake) when another, uninsured peril occurs at around the same time
 - Mold — Reduced/eliminated coverage entirely except if caused by another peril
 - Dog-bite liability — Certain dog breeds excluded (e.g., Rottweiler, Pit Bull) or surcharged. Dog bites account for one-third of homeowners liability claims
 - Capped replacement cost coverage — Most carriers limit replacement cost to the stated value in the policy
 - Policyholder can purchase extended replacement cost (e.g., approximately 120% of stated value) for additional charge
- Companies are trying to differentiate themselves through product offerings
 - Optional endorsements (e.g. identity theft coverage)
 - “Green” coverage (eco-friendly homes, energy-efficient building material and appliances)
 - Deductible reserve (e.g., credit 10% of the deductible to a reserve account for each year with no claims, which is used to reduce the deductible payment on the first claim)
 - Claims forgiveness (paid up-front or based on policy tenure)
 - Discounts

Underwriting

- Focus is increasing on underwriting/rating
 - The home (historical losses from CLUE)
 - The owner (credit scoring)
- Tighter underwriting guidelines have been implemented by many companies
 - Underwriting may be restricted following a large event or when needed rate increases are not approved (e.g. Florida)
- Better integration of modeling at point of sale
 - Desk-top modeling tools used by underwriters, especially in catastrophe-exposed areas, with real time results
- Insurers re-underwriting book
 - Increased used of expert underwriting tools to reevaluate amount of insurance
 - Deductibles reevaluated
 - Higher windstorm deductibles and percentage deductibles are common
- Companies spending more on loss prevention
 - Home inspections becoming more extensive (satellite imagery, cameras on extension poles to check roof characteristics, presence of dogs, etc.)

Rating

- Implementation of more sophisticated rating plans
- Use of predictive modeling
- Pricing by peril, including varying territories by peril
- Increasing number of variables used in rating algorithms
- New variables include:
 - Owner characteristics — credit, age of owner, number of years at residence, presence of children, presence of animals
 - Policy information — prior claims history by peril, premium payment modes, multiple-line relationships, coverage and/or loss experience for other lines
 - Home characteristics — number of stories, square footage, roof characteristics (age, type, geometry), type of foundation, percent of basement finished
- Complex interactions between variables becoming more common
- Increasing use of predictive modeling analytics techniques
 - Rating for expenses separately, with new business costs and expected policy longevity considered in the expense component
 - Detecting claims fraud

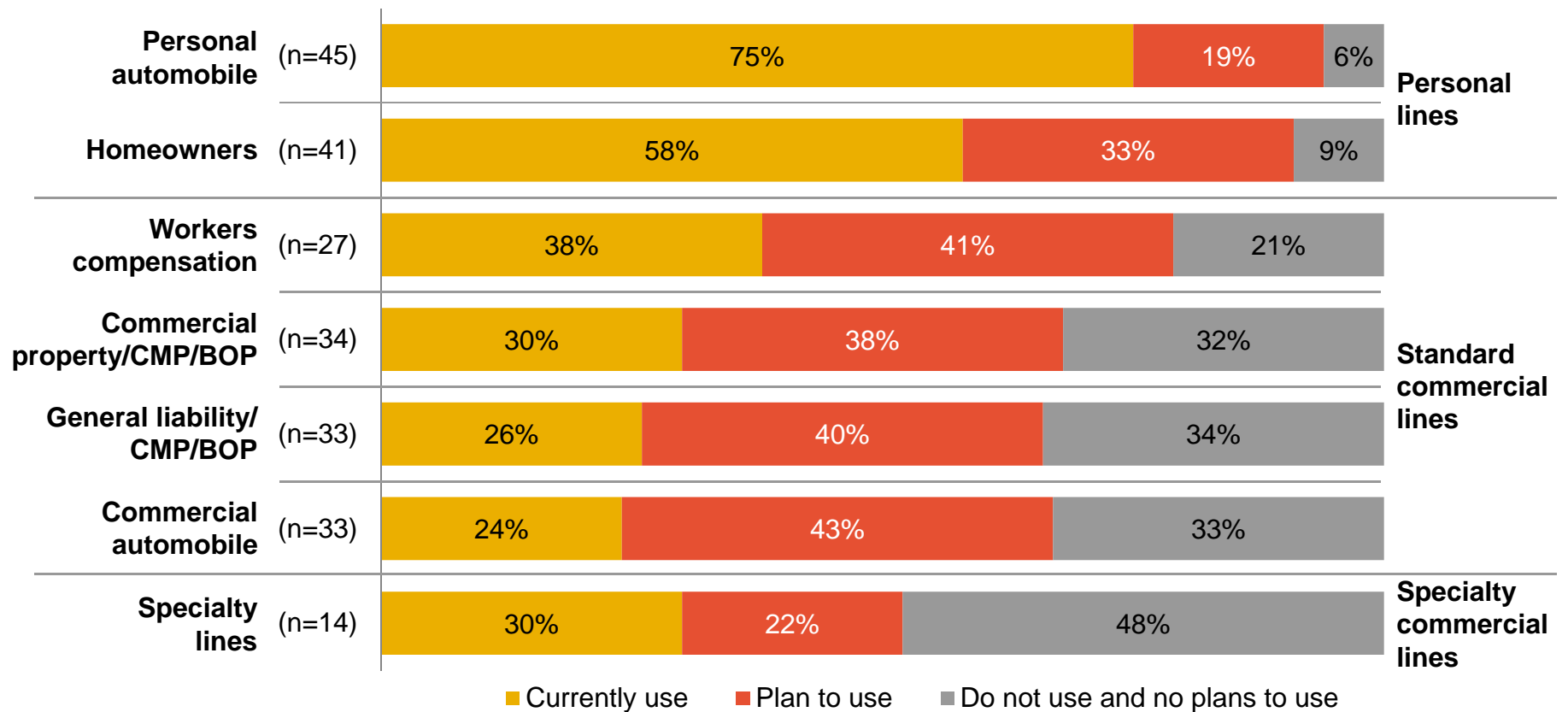
Towers Watson's Predictive Modeling Survey

Towers Watson's Predictive Modeling Survey

- Towers Watson conducted a Web-based survey of U.S. and Canadian property and casualty insurance executives from September 13th through October 24th, 2012
- This survey explores the extent to which insurers are developing and implementing predictive models to support their underwriting/risk selection and/or rating/pricing efforts, and potentially other areas
- A total of 63 U.S. and 9 Canadian executives responded
- Responding companies represent a significant share of the U.S. property and casualty insurance market for both personal lines carriers (17%) and commercial lines carriers (21%)
- The complete report shows results for U.S. insurers, with a comparison of results for the U.S. and Canada in a separate section
- The following slides are a small excerpt of the complete report

Use of predictive modeling for homeowners lags only personal auto

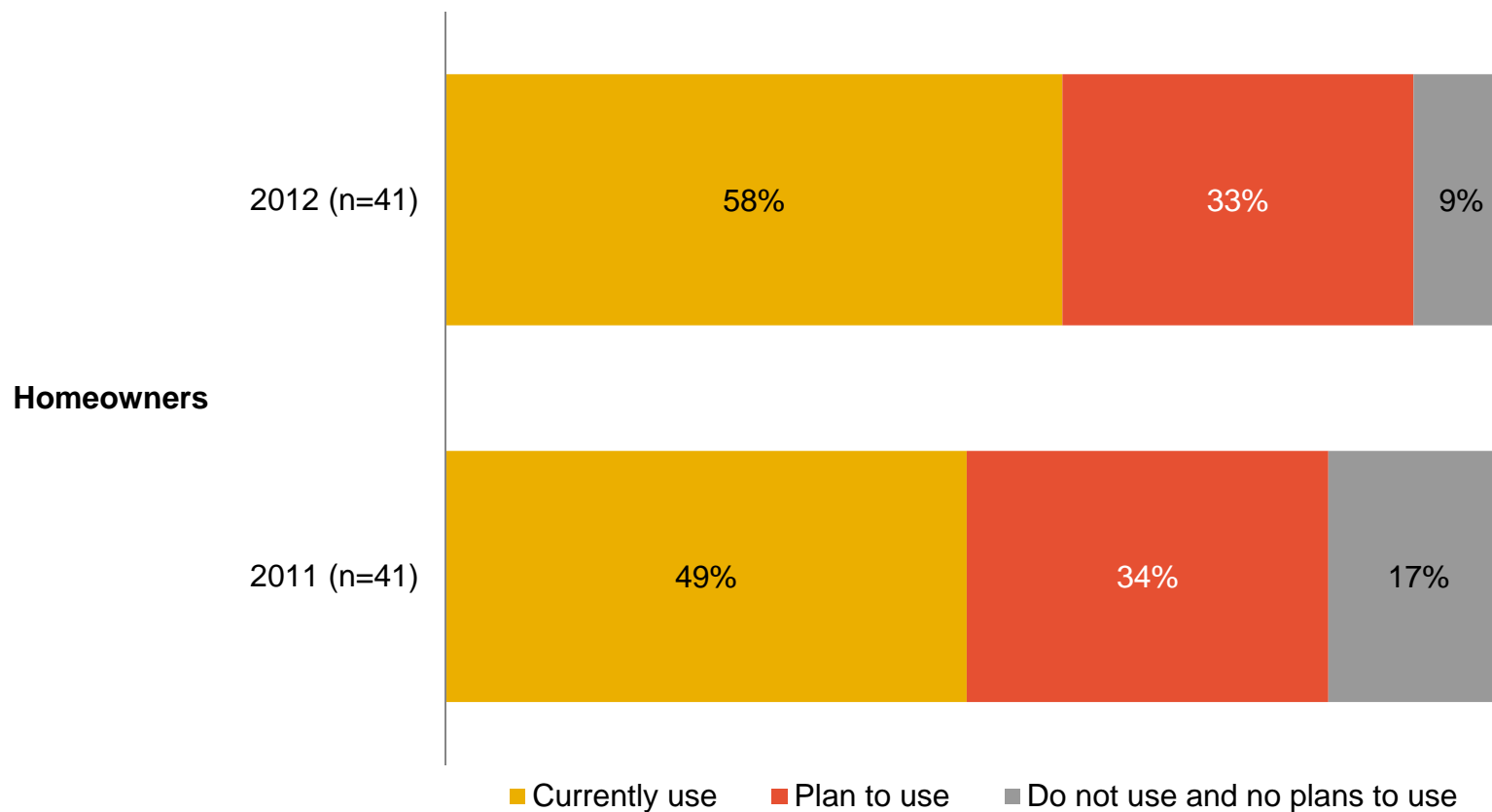
Does your company group currently use, or plan to use, predictive modeling in underwriting/risk selection and/or rating/pricing for the following lines of business?



Base: U.S. respondents giving a valid answer (percentages exclude 'Do not write this line of business').

Use of predictive modeling has grown substantially over the short-term

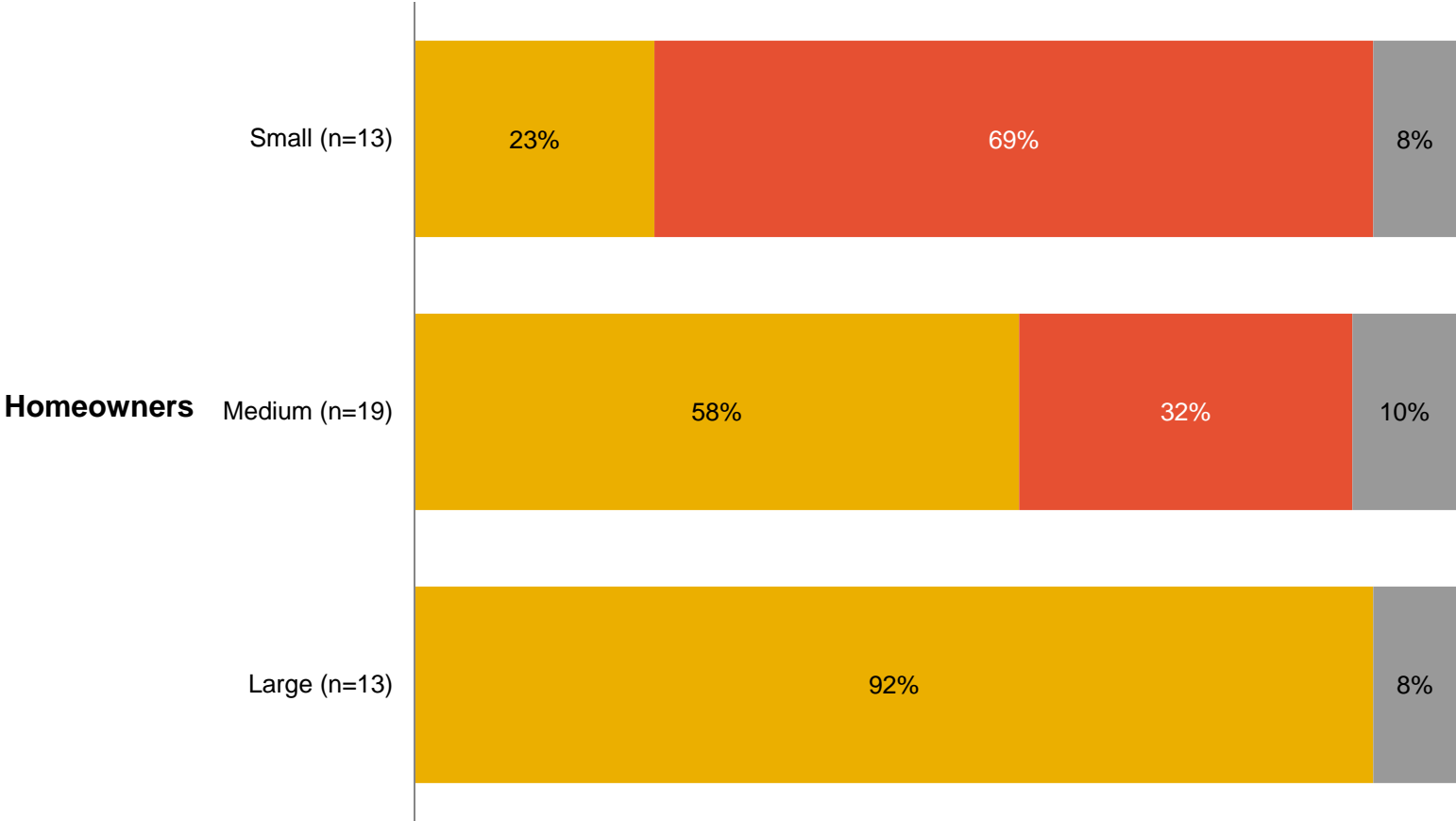
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Predictive modeling is used more extensively by large carriers

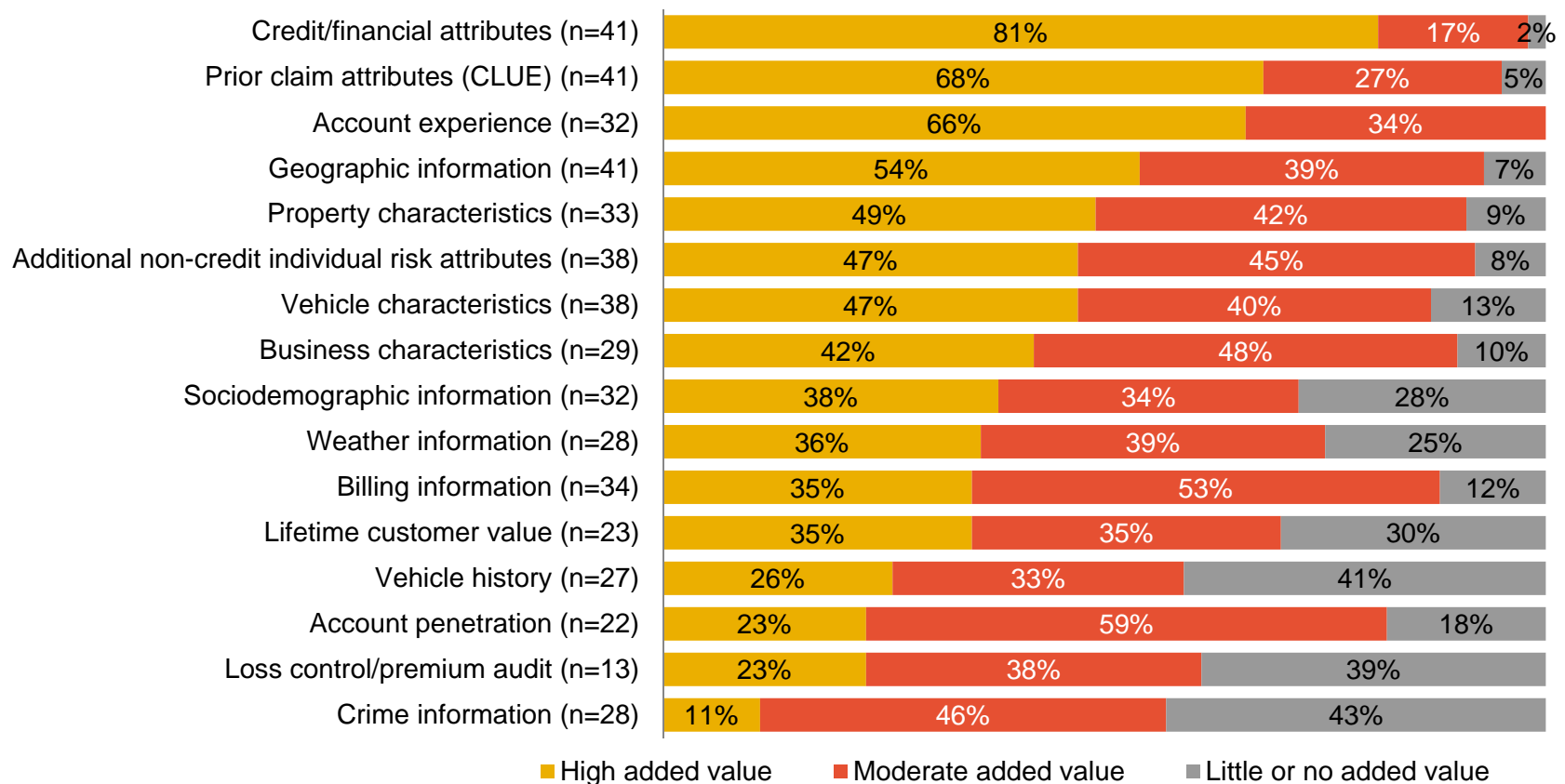
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Base: U.S. respondents giving a valid answer (percentages exclude 'Do not write this line of business').

Credit/financial attributes and prior claim attributes provide the most lift in increasing pricing sophistication; many variables provide at least some added value

What amount of value have the following internal/external predictors added to your pricing sophistication?

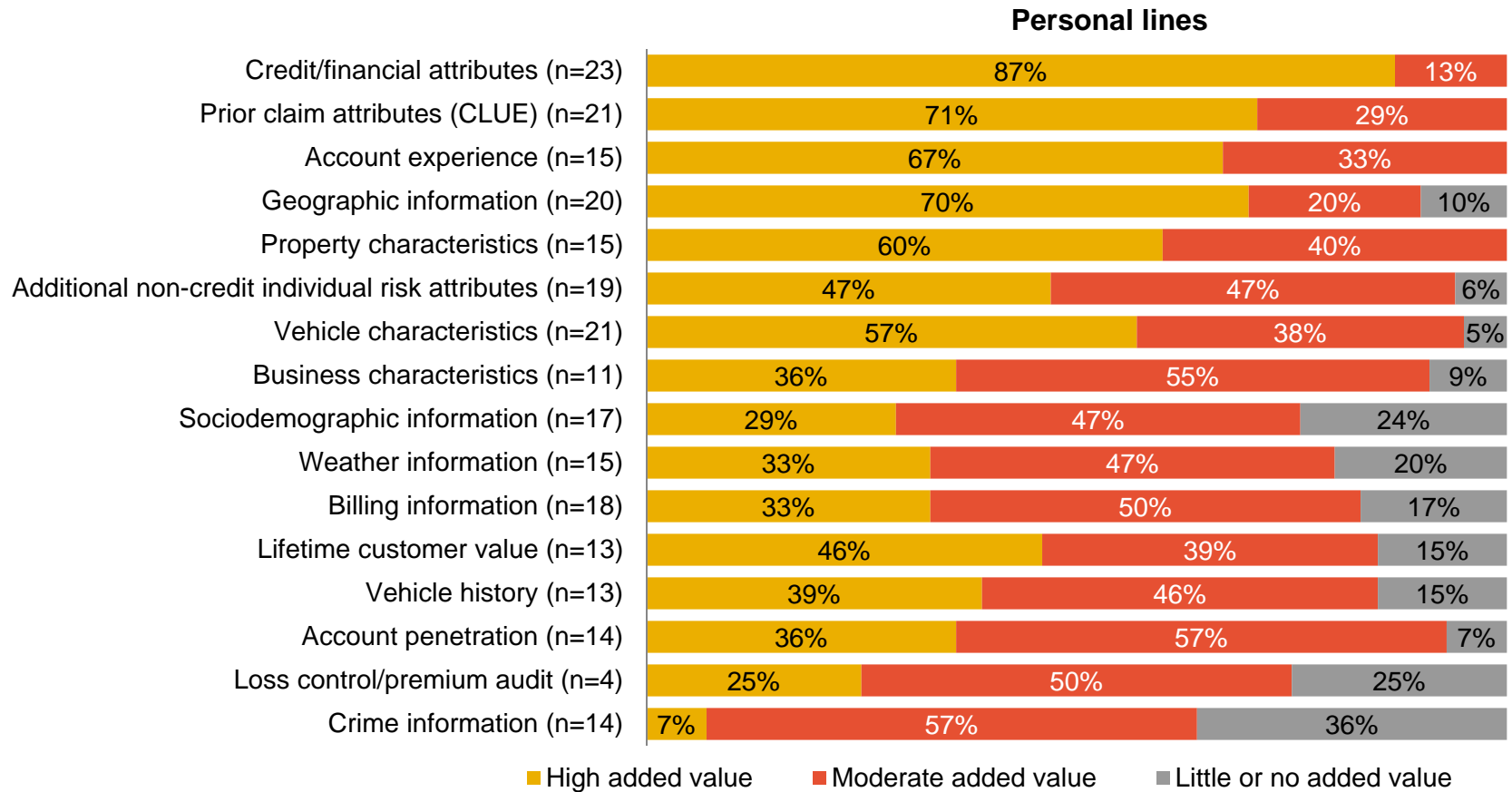


Base: U.S. respondents currently using predictive modeling for at least one line of business (percentages exclude 'Do not know/not applicable')

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In personal lines, the top three predictors are credit/ financial attributes, prior claim attributes and geographic information

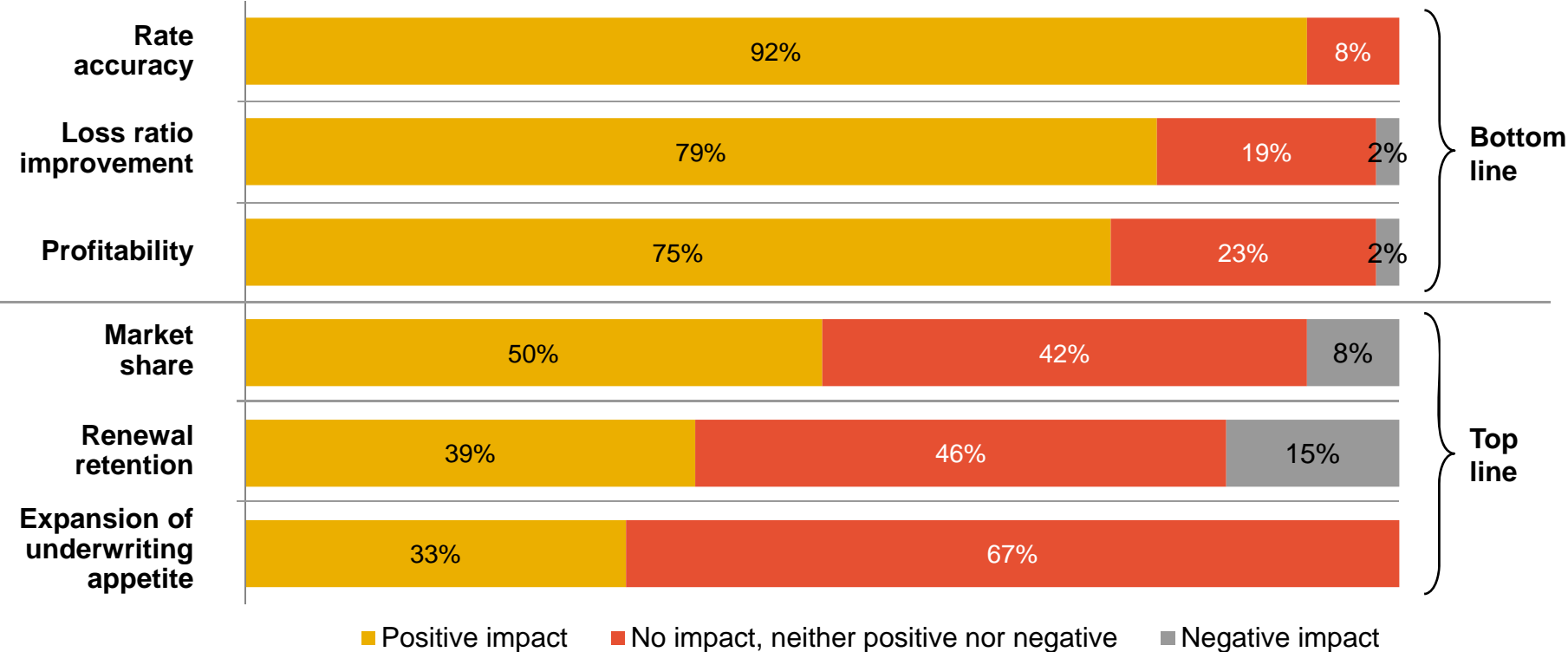
What amount of value have the following internal/external predictors added to your pricing sophistication?



Base: U.S. respondents currently using predictive modeling for at least one line of business (percentages exclude 'Do not know/not applicable')

Most carriers improve their bottom-line profitability through the implementation of predictive models; top-line growth impacts are less pervasive across the industry

What impact has predictive modeling had in the following areas?



Base: U.S. respondents currently using predictive modeling for at least one line of business (percentages exclude 'Do not know/to be determined') in 2012 (n=48) and 2011 (n=41)